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UNCLAS SECTION 01 OF 02 YEREVAN 001453

SIPDIS

SENSITIVE

STATE FOR EUR/CACEN FOR SIDEREAS, EUR/ACE FOR LONGI, EB/ESC,
PASS TO USAID EGAT FOR WALTER HALL

E.O. 12958: N/A
TAGS: ECON ENRG AM
SUBJECT: ARMENIA RELUCTANT TO DISSOLVE ARMENERGO: RIGHTFULLY
SO?

SENSITIVE BUT UNCLASSIFIED. PLEASE PROTECT ACCORDINGLY

SUMMARY

¶1. (SBU) An IMF conditionality and commitments to other donors, including the United States (as part of the USATF action plan), oblige the Government of Armenia to eliminate by July 31 ArmEnergo, a state-owned enterprise that is the single buyer of midstream electricity. Once ArmEnergo is eliminated, the electricity distribution company, Electricity Networks of Armenia (ElNetArm), must negotiate contracts with all of Armenia's generating enterprises, as well as the calculating center, national traffic management and high-voltage power networks. Because the Public Services Regulatory Commission has not yet established market rules for the energy sector or adopted an energy adjustment clause, premature dissolution of ArmEnergo would put private energy companies in an untenable situation. Sources close to the Ministry of Energy say that, despite press reports to the contrary, ArmEnergo will necessarily exist until there is a viable alternative in place, almost certainly past the July 31 deadline. End Summary.

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ARMENERGO: GUARANTOR OF THE ARMENIAN ENERGY SECTOR
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¶2. (SBU) Since privatization of its electrical distribution function, ArmEnergo has acted as a single-buyer single-seller mediator of electricity, in effect making the Government of Armenia the guarantor of the Armenian energy sector. The Ministry of Energy has used adjustments in the profits of ArmEnergo to keep end-use prices stable when generation costs have fluctuated. Due to lack of transparency in its operations, it has also been subject to political interference and funds diversion. The Government of Armenia committed to the IMF to dissolve ArmEnergo by July 2004. The commitment also appears in the May 2004 U.S. Armenia Task Force Draft Action Plan.

THE BUCK STOPS WHERE?

¶3. (SBU) It remains unclear what system will replace ArmEnergo. Armenia has committed to a system whereby the privately owned electricity distributor, Electricity Networks of Armenia (ElNetArm) independently negotiates contracts with Armenia's generating enterprises as well as the national traffic management. This does not eliminate a single-buyer from the system but rather transfers that unenviable role to ElNetArm, who currently must provide electricity at a tariff comprising a weighted average of supply costs based on a mix of hydro, nuclear and thermal generation. The Public Service Regulatory Commission (PSRC) has been reluctant to adopt an energy adjustment clause, which would give the distributor the right to raise electricity prices for end-users when the average costs from generation rise. Without adjusting its tariff to account for a change in the composition of generation, ElNetArm loses USD 4 million each month that the Armenia Nuclear Power Plant does not operate. (Note: The ANPP shuts down annually for maintenance and refueling. Longer closures due to lack of fuel have also occurred in the past. End note.) ArmEnergo is also vulnerable to significant drops in cheap hydroelectric production during an unusually dry year. Without an adjustment clause and without rules that control ElNetArm's energy costs, ElNetArm would operate in the red and quickly use its cash reserves in the (not unlikely) event that generation costs exceed the tariff. In the worst-case scenario, ElNetArm would buy and distribute only that electricity it could purchase for less than the tariff, an understandable but undesirable outcome that would lead immediately to power outages and would be potentially very damaging to the government. (Note: Armenian consumers can currently count on reliable power supplies throughout the country. Almost all power interruptions are brief and

caused by short-term technical problems. End note.)

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PSRC RESISTING THE ADOPTION OF MARKET-BASED REGULATION
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¶4. (SBU) The PSRC has argued to preserve ArmEnergo for now and has resisted the adoption of rules governing tariff adjustment. The PRSC has also resisted putting market rules governing these transactions into a regulatory framework, instead preferring to include rules in independent licenses and contracts. Dispatch, import and export rules, which govern the seasonal swap with Iran and export to Georgia among other things, would affect ElNetArm's bottom line following the dissolution of ArmEnergo, and would affect end-user electricity costs if ElNetArm had an adjustment clause. Comment: Hiding such rules in a web of contracts and licenses creates a weak base on which a private network of generators, distributors, and customers cannot reasonably rely. End Comment.

COMMENT

¶5. (SBU) The PSRC's actions indicate a desire to leave the government as the guarantor of both steady supply and steady prices in the energy sector. The government seemingly finds the continued existence of ArmEnergo to be the most convenient way to do so, as it allows the government to absorb energy sector profits as well as losses (although there is justified suspicion that profits are diverted before reaching the government's coffers--another possible factor in the reluctance to eliminate ArmEnergo). Until the government is committed to establishing market relations between the private players in the energy sector that may result in price rises, the elimination of ArmEnergo alone could cause more harm than good. The establishment of rules by contract and license rather than law will lend itself to abuse, non-transparency, and distorted incentives. In the absence of ArmEnergo, the lack of rules and of an adjustment clause would put private energy firms, especially ElNetArm, in an untenable situation, and could give private companies an incentive to produce, buy or distribute too little electricity.
ORDWAY